SUBMITTED ELECTRONICALLY

November 1, 2013

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: OFFICE OF FINANCIAL RESEARCH, "Asset Management and Financial Stability (September 2013)

Dear Ms. Murphy:

The Financial Services Roundtable ("FSR")[1] extends its appreciation to the Securities and Exchange Commission (the "Commission") for providing an opportunity for us to comment on the study, "Asset Management and Financial Stability" (the "Study"),[2] prepared by the Office of Financial Research of the Department of the

[1] As *advocates for a strong financial future*™, FSR represents 100 integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. FSR member companies provide fuel for America's economic engine, accounting directly for $98.4 trillion in managed assets, $1.1 trillion in revenue, and 2.4 million jobs.

[2] The Study is available at http://www.treasury.gov/initiatives/ofr/research/Documents/OFR_AMFS_FINAL.pdf.

Treasury ("OFR") at the request of the Financial Stability Oversight Council (the "Council").

The Council commissioned the Study in order to "inform its analysis of whether—and how—to consider [asset management] firms for enhanced prudential standards and supervision"[3] within the meaning of section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[4]

FSR has several substantive concerns with the Study. First, the failure to adopt a sound methodology for conducting the Study has resulted in a report that lacks rigor, balance and perspective. Second, the Study appears to be flawed in its analyses of (i) asset management firms as sources of systemic risk, (ii) redemption risk, (iii) asset management firms' connections with the financial industry, (iv) the principal-agent relationship between asset managers and their clients as a source of systemic risk, and (v) the use of leverage. Third, the Study reflects a fundamental misunderstanding of the asset management industry, how asset management firms operate, and the expectations of investors in the capital markets. In particular, the Study fails to appreciate the fact that investors will take on greater risk in order to receive the potential for greater return. Fourth, the Study gives insufficient weight to the comprehensive regulatory régime imposed on asset managers and the industry by several U.S. regulatory agencies, including the Commission, and non-U.S. regulatory agencies, particularly with respect to the new regulatory requirements imposed since the Dodd-Frank Act.[5] Finally, the Study fails to appreciate the important role that asset managers play as agents acting on behalf of millions of individual and institutional investors who participate in U.S. capital markets and the contributions that asset managers make to the financial stability of the United States.

Based on the many issues with methodology and analysis in the Study, FSR urges the Commission, drawing on its expertise in regulating the asset management industry, to call upon OFR to withdraw the Study. OFR should coordinate and collaborate with the members of the Council with the greatest knowledge of the asset management industry,

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[3] Study at 1.

[4] Pub. L. No. 111-203, § 113, 124 Stat. 1398-1402 (July 21, 2010).

[5] Similarly, the Study does not discuss the significant new regulatory requirements imposed on the financial industry participants who interact with asset managers and their clients, including as service providers (such as custodial banks) and investors.

including the Commission and the Commodity Futures Trading Commission (the "CFTC"), on any future study.[6]

I. Executive Summary

- Asset management firms do not pose a threat to the financial stability of the United States because they do not invest for their own account as principal, and the legal structures of funds, separate accounts and other products expressly limit the liability exposure.

- Asset management firms are subject to extensive regulatory scrutiny under the federal securities, commodities, and banking laws.

- Due to its flawed methodology, the Study lacks rigor, balance and perspective. For example, the Study makes numerous unsupported assertions, presents anecdotes and examples in the place of empirical data, and fails to analyze how asset managers positively impact the financial stability of the United States.

- Asset management firms are not sources of systemic risk, and the Study does not present any data to support its claim that the impact on the reputation of a firm by a single product could spread to the asset management firm sponsoring the product and other products sponsored by the same firm in a fashion that would threaten the financial stability of the United States.

- The Study neither presents data that support its claims that mutual funds pose redemption risks, nor analyzes why investors holding mutual fund shares should be subject to potential trading restrictions when investors directly holding equity securities are not.

- The Study hypothesizes a variety of connections between asset management products and the financial industry (including counterparties, investors, and service providers) but fails to consider their fundamental differences or to establish definitively which of the connections could actually transmit systemic risk.

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[6] Based on several press reports, it appears that this collaboration did not occur with respect to the Study, which may, in part, explain the many defects with the Study. *See*, *e.g.*, Sarah N. Lynch, "SEC sees flaws in new Treasury asset manager report: sources," REUTERS (Oct. 7, 2013); Gina Chon & Stephen Foley, "SEC move on asset managers risk regulatory turf war," FINANCIAL TIMES (Oct. 14, 2013).

- The Study inappropriately implies that the "principal-agent" relationship between an asset manager and its clients poses systemic risks, particularly where an investor fails to appreciate the risks taken by the asset manager.

- Unlike persons who deposit funds in a bank account insured by the Federal Deposit Insurance Corporation, investors do not seek shelter from risk. Rather, investors participate in capital markets transactions (including buying and selling securities, securities lending, and entering into repurchase agreements) because they seek a certain level of risk and the opportunity to obtain the corresponding financial rewards of their risk-taking.

- Although leverage will change the risk-return profile of a strategy, the use of leverage does not inherently delegitimize the strategy because it involves greater risk than other types of investments along the "risk-reward" continuum.

- The Study's review of the potential data gaps indicates that the enormous volume of data that asset management entities already report to various regulators has yet to be analyzed. Moreover, the Study does not present a cost-benefit analysis of any new reporting requirements.

II. Asset Management Firms Do Not Present Systemic Risks

As has been explained on many occasions by various groups and firms in the asset management industry throughout the process the Council has followed to consider how to identify a systemically important nonbank financial institution,[7] asset management firms do not present systemic risks because (i) asset management firms are not in the business of investing for their own account as principal,[8] (ii) the legal structures of the asset management products (such as funds and separate accounts) and of asset management firms expressly limit the liability exposure, (iii) investors in asset management products

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[7] *See, e.g.*, Comments on Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (Docket No. FSOC-2011-0001) by BlackRock, FSOC-2011-0001-0022 (Feb. 25, 2011) and FSOC-2011-0001-0070 (Dec. 19, 2011); Fidelity Management & Research Company, FSOC-2011-0001-0078 (Dec. 19, 2011); Investment Company Institute, FSOC-2011-0001-0035 (Feb. 25, 2011) and FSOC-2011-0001-0083 (Dec. 19, 2011); Managed Funds Association, FSOC-2011-0001-0040 (Feb. 25, 2011); Private Equity Growth Capital Council, FSOC-2011-0001-0028 (Feb. 25, 2011) and FSOC-2011-0001-0059 (Dec. 19, 2011); Vanguard, FSOC-2011-0001-0029 (Feb. 25, 2011); and U.S. Chamber of Commerce, FSOC-2011-0001-0038 (Feb. 25, 2011).

[8] An asset management firm may engage in a small amount of principal investing for purpose of seeding a new fund or making a co-investment intended to show to investors that the sponsor and its employees have "skin in the game."

do not have any reasonable expectation that they are acquiring a guaranteed product or a product that does not have a risk of loss, (iv) the asset management industry is highly competitive, and (v) asset management firms already are subject to extensive regulatory scrutiny in the United States under the federal securities, commodities, and banking laws.

Asset managers act as agents investing on behalf of clients and are not in the business of proprietary trading. Therefore, asset managers generally hold only a minimal amount of investments on their balance sheets (mainly for seeding funds and certain co-investments)[9] and have little borrowing or counterparty exposure at the firm level. Similarly, asset managers generally rely on fee income as their principal income source rather than investment performance. Therefore, as discussed more fully below, the balance sheets of asset management firms are generally stable even during financial crises and are not at risk of "material financial distress… [that] could pose a threat to the financial stability of the United States."[10]

The products that asset management firms offer (including registered funds, private funds, and separate accounts) are generally organized and operated as separate legal entities whose assets are owned by clients and primarily maintained in third-party accounts by independent custodians.[11] As a result, the funds and other products are not exposed to the liabilities of the particular asset management firm, and the funds and other products are not exposed to the liabilities of each other. This legal structure prevents any direct "spillover" from losses within one product; and, where necessary, it can facilitate a liquidation of that product without impacting other products.

Investors are well aware that investments necessarily entail the potential for a risk of loss (which may be a total loss of the investment) and, therefore, do not have the expectations of a customer with a deposit in a federally guaranteed bank account.

[9] The vast majority of asset management firms operate as stand-alone businesses. However, certain asset management firms may operate as affiliates of banks, insurance companies, or securities brokers or dealers, and the affiliated entity may have substantial investment assets on its balance sheets. The asset management affiliates of these entities generally have small balance sheets. In addition, certain asset management businesses may be operated within a single financial entity such as a bank; however, the portion of the balance sheet that is attributable to the asset management businesses (including principal investments and sponsor support) remains small.

[10] Dodd-Frank Act, Section 113.

[11] We also note that the many of the custodians have already been designated as systemically important financial institutions, including the four largest custodians. Trefis Team, "Is BNY Mellon's Custody Banking Growth Slowing," FORBES (May 15, 2013). We also note that The Depository Trust Company was designated as systemically important financial market utility, in part, because it provides depository services for a wide range of securities. Designation of Systemically Important Financial Market Utilities, *available at* http://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx, at 164.

Investors choose to participate in capital markets transactions—like buying and selling equity and fixed income securities, engaging in securities lending, or conducting transactions in the repo market—because they seek a certain level of risk and the opportunity to obtain the corresponding financial rewards of their risk-taking. They are *not seeking protection from risk* (as would be the case for persons or institutions who deposit funds in a depositary account insured by Federal Deposit Insurance Corporation (the "FDIC")), and they understand that their investment activities are not guaranteed—whether by any government or other agency, or by the asset manager.

The fundamentally different implications of losses on an investment and losses on a bank deposit are, therefore, important not only for the individual bearing the loss but also for the system. A potential risk of the failure of a commercial bank is that the depositor loses the money deposited into a checking, savings or other account with the bank. Depositors are unwilling to accept the risk of loss, and the threat that bank failures pose to financial stability is significant. In fact, it is so significant and happens with such frequency that the federal government has created a "safety net" in the forms of FDIC deposit insurance and access to credit from the Federal Reserve Banks through discount window programs to make bank failures less likely and mitigate their systemic impacts. Furthermore, the FDIC is responsible for resolving bank failures so as to minimize their impacts on depositors and the financial stability of the United States.

Investments receive no such federal support and require no special resolution régime because investment losses have very different implications for investors and for the financial system than losses on bank deposits. Losses on investments (including retirement accounts, individual accounts, mutual fund accounts, *etc.*)—some of which may be substantial—happen every day. In the capital markets, there is someone on both sides of every trade. Mutual funds and other investment vehicles rise and fall in value. Funds open and close regularly as part of the normal business cycle.[12] Investments do not require regulatory "safety nets" because investors are *buying* risk when they make an investment; they are not seeking shelter from it as they do when they deposit their money in a bank.

Asset managers operate in a highly competitive industry. There are nearly 11,000 investment advisers registered with the Commission who advise approximately 9,700

[12] For example, during 2012, 628 new mutual funds were opened, 197 were merged and 296 were liquidated. Investment Company Act Institute, 2013 Investment Company Fact Book (53rd ed.) ("ICI Factbook 2013") at 15. This process also takes place at the sponsor level. For example, from 2009 to 2012, 224 new investment company sponsors entered the business and 129 firms left the business. ICI Factbook 2013 at 14.

mutual funds and exchange traded funds ("ETFs") and 30,000 private funds.[13] The competitiveness of the asset management industry promotes a flexibility that softens any failure of a fund or other asset management product or of an asset management firm, as investors have thousands of alternative sources for asset management services offering a wide range of investment strategies.[14]

Asset managers also are subject to substantial oversight and regulation under federal securities, commodities, and banking laws, including, among other laws, the Investment Advisers Act of 1940 (the "Advisers Act"),[15] the Investment Company Act of 1940 (the "Investment Company Act"),[16] and the Commodity Exchange Act.[17] Many of the issues raised by the Study are appropriately within the jurisdiction of the Commission, and have historically been subject to the Commission's interpretative guidance or regulations. These regulations require extensive disclosure to investors (and, for mutual funds, to independent boards of directors) on, among other things, the investment strategies of the asset management products, the risks associated with those strategies and any conflicts of interest between the asset manager and the client.[18] The asset manager acts as a fiduciary to the client, which means, among other things, that it has a duty to act in the best interests of the client and make full and fair disclosure of material information.[19] The Investment Company Act also has a number of requirements relating to, among other things, the use of leverage and liquidity, and the role of

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[13] Chair Mary Jo White, Remarks at National Society of Compliance Professionals National Membership Meeting (Oct. 22, 2013), *available* at http://www.sec.gov/News/Speech/Detail/Speech/1370539960588.

[14] *See supra* note 12.

[15] 15 U.S.C. 80b-1 *et seq*.

[16] 15 U.S.C. 80a-1 *et seq*.

[17] 7 U.S.C. 1 *et seq*.

[18] *See*, *e.g.*, Form N-1A, Item 4 ("Risk/Return Summary: Investments, Risks and Performance"); Form ADV, Part 2A, Item 8 ("Methods of Analysis, Investment Strategies and Risk of Loss"); Disclosure Document or Statement of Additional Information, as specified by CFTC Regulations Part 4 ("Risk Disclosure Statement," "The Investment Program," "Principal Risk Factors," and "Conflicts of Interest").

[19] *See*, *e.g.*, SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963)(interpreting Section 206 of the Advisers Act to impose a fiduciary duty on investment advisers); In the Matter of Arleen W. Hughes, SEC Release No. 34-4048 (Feb. 18, 1948)(discussing the elements of fiduciary duty). In addition, an asset manager may face fiduciary duties under the Employee Retirement Income Security Act of 1974 ("ERISA") and state law.

governance through an independent board.[20] Although these regulations are designed to protect investors and promote market integrity, they have beneficial effects on financial stability as well.

The Study also fails to appreciate fully the ways in which the regulatory landscape has changed since the 2008 financial crisis, including the enactment of the Dodd-Frank Act and limitations on sponsor support, as discussed more fully below. The Dodd-Frank Act addressed the potential impact of many activities in which investors engage—including asset managers. For example, section 984 of the Dodd-Frank Act[21] authorized the Commission to propose and adopt rules designed to increase the transparency of information available to brokers, dealers, and investors, with respect to the loan or borrowing of securities.

III. Methodological Flaws

We believe a more thorough approach to the Study would have served to better inform the judgment of the members of the Council. Certain flaws in the Study's methodology limit the utility of the Study. For example, there is no disclosure of the number of asset management firms or other persons with whom OFR consulted, how these firms or other persons were selected, and what information was requested and provided by these firms and other persons.[22]

In our view, a more constructive approach would have included—at a minimum—consultations with a wide range of asset managers, individual and institutional investors, and regulators—particularly those with expertise in capital markets regulation. OFR also could have published a preliminary findings report and solicited public comment prior to submitting the final report to the Council.

Unfortunately, the results of the Study reflect the limitations of OFR's narrow approach. As we note below, the Study makes numerous assertions without any citation

[20] *See, e.g.*, Investment Company Act Section 18 (concerning the capital structure); Revisions of Guidelines to Form N-1A, SEC Release No. IC-18612 (Mar. 12, 1992)(concerning liquidity).

[21] Pub. L. No. 111-203, § 984, 124 Stat. 1932-33 (July 21, 2010).

[22] In comparison, we note that the U.S. Government Accountability Office (the "GAO") typically provides detail on the methodology of the study in its report. *See*, *e.g.*, GAO, Requirements and Costs Associated with the Custody Rule, GAO-13-569 (Jul 8, 2013) at 23 – 26 (including a discussion of how the investment advisers were selected to be interviewed).

or other support.[23] Anecdotes are presented as data and the examples in certain sections of the Study often do not support the assertions surrounding them.[24] Moreover, the academic papers that are cited (i) often do not support the conclusions stated, (ii) have a narrower focus, or (iii) include other conclusions that are not discussed or distinguished in the Study.[25]

The Study mixes the analysis of a wide range of investment activities (*e.g.*, securities lending, repurchase transactions (or "repos"), hedging strategies, derivatives, asset allocation, and portfolio selection) and asset management products (*e.g.*, mutual funds, private funds, and separate accounts) that asset managers use to provide a broad and diversified mix of investment strategies to meet the unique needs, investment goals and risk tolerance of their clients. In so doing, the Study conflates the different risks facing these activities, products and strategies. For example, while mutual funds may face increased redemption risk, they also are subject to strict liquidity and leverage restrictions.[26] A thorough methodology would systematically evaluate the risks and any transmission channels associated with each asset management product category separately (including significant subcategories).

Moreover, the Study fails to consider the positive ways in which asset managers impact the stability of the financial system. For example, the Study observes that asset managers often have the financial strength and liquidity to purchase assets trading significantly below their intrinsic values and therefore potentially could help stabilize declines in prices during periods of market stress.[27] The Study, however, does not

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[23] *See, e.g.*, Study at 19 ("Under stress, counter-parties also might not distinguish among exposures to the firm and its funds, and therefore could take risk-mitigating actions that could aggravate risks across the firm's funds and accounts.").

[24] *See, e.g.*, Study at 14 (discussing Bank of America's support for Strategic Cash Portfolio in November 2007 without acknowledging that the fund was liquidated and without providing any evidence of further financial distress).

[25] *See, e.g.*, Study at fn. 8 (citing studies concerning herding in small-capitalization securities to support a concern for herding in securities "regardless of the size or liquidity"); Study at fn. 42 (in support of the statement that risks can transmit across related funds, the Study cites one paper that indicates that an asset manager of a fund of funds would actually reduce risk by spreading the redemption pressure across affiliated funds and another paper that discusses favoring well-performing funds over poor performing funds); Study at fn. 52 (failing to note that the paper also concluded that stocks with high fund ownership was correlated with lower capital depreciation than other stocks).

[26] *See, e.g.*, Investment Company Act Section 18 (concerning the capital structure); Revisions of Guidelines to Form N-1A, SEC Release No. IC-18612 (Mar. 12, 1992)(concerning liquidity).

[27] Study at 12.

explore or seek out other ways in which asset managers reduce systemic risks. For example, the Study neglects the finding in one of the studies it cites that stocks with higher fund ownership performed better than stocks with lower fund ownership during the last financial crisis.[28] One of the conclusions of Hau and Lai was that "during bad times (*i.e.*, when the overall index is strongly declining), stocks mostly held by funds experience less selling pressure than those primarily held directly by retail investors."[29]

Taken together, FSR believes the apparent absence of a rigorous approach to collect and understand the relevant data, the failure to present strong supporting data, and the failure to conduct a thorough analysis of the positive contributions of the asset management industry give the impression that the Study was not developed in a balanced fashion. Given these flaws, the Study is unreliable and cannot inform policy discussions or serve as the basis for regulatory actions.

IV. Asset Management Firms Are Not Sources of Risk

The Study hypothesizes a risk transmission process that moves from a particular product (*e.g.*, funds and separate accounts) to the asset management firm itself and then to other products managed by the asset management firm.[30] At various points, the Study postulates that this transmission may occur because of (i) reputational effects on the firm and its products, (ii) sponsor support of its products, (iii) principal investing by sponsors, and (iv) spillover between related funds. However, none of these transmission methods reflect the nature and structure of the asset management business, its regulation, or have support in any empirical data. Nor does the Study reflect the moderation on asset manager risk appetite posed by the broad discretion accorded to the client to replace the manager.

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[28] Harald Hau and Sandy Lai, "The Role of Equity Funds in the Financial Crisis Propagation," Research Paper No. 11-35, Geneva: Swiss Finance Institute (June 2, 2012) ("Hau and Lai").

[29] Hau and Lai, *supra* note 28, at 3.

[30] *See*, *e.g.*, Study at 13 (discussing "redemption risk" and stating that "[i]nvestors' concerns about the liquidity of one fund can quickly spread to similar or related funds, or to the sponsor of a fund complex. As an agency business, a financial services firm that suffers damage to its reputation through an extreme event in one business or fund may suffer redemptions or creditor pull-backs in its other funds or businesses"); Study at 18 (discussing leverage and noting two situations where sponsors were found liable for misrepresentations as to the use of leverage); Study at 18 – 20 (discussing firms as sources of risk); Study at 22 (discussing "reputation risk" within the context of "fire-sale risk" and stating that "If an asset manager or one of its specialized funds suffers damage to its reputation, the redemption risk for the asset manager's funds could increase and heighten fire-sale risk").

A. *Reputational Impact*

The Study presents no data to support its claim that the impact on the reputation of a firm by a single product could spread to the asset management firm sponsoring the product and other products sponsored by the same firm in a fashion that would threaten financial stability of the United States.[31] In fact, several of the examples the Study presents indicate that even the liquidation of a product may not cause a "run" on other products.[32]

In our view, a "run" based on reputation would be unlikely to impact the financial stability of the United States. Since the investor behavior would appear to be related to the reputation of the firm and not a change in the desirability of the underlying assets, one would expect that many of the investors who are redeeming or removing their investments would move them to funds or to accounts at other asset managers who are pursuing similar strategies. In this way, the investor could maintain a similar overall portfolio diversification strategy. This dynamic would limit any impact on the underlying assets, since the sales by the firm who has suffered the reputational impact will be offset by purchases by the firm or firms to whom the investor transfers its assets. The Study presents no data or economic analysis of how a "reputation run" on the other funds of an asset manager would impact the underlying assets.

The Study also expresses concern that "problems associated with an activity involving a large number of asset managers could affect market confidence and lead to redemptions."[33] The Study does not provide any examples or data of such issues, nor does it attempt to model the impact of these activities on the financial stability of the United States. In fact, the Study does not acknowledge or analyze the historical situations (*e.g.*, the issues relating to market timing in mutual funds) where investor confidence in a large group of asset managers arguably could have been negatively impacted but there were no unmanageable redemptions or a financial crisis.

The Study makes a statement that counterparties "might not distinguish among exposures to the firm and its funds" but provides no support for this assertion.[34] Substantially all counterparties of asset management products are sophisticated financial parties who are well aware of the legal structures of asset management firms and their

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31 Dodd-Frank Act Section 113.

32 *See, e.g.*, Study at 14 (discussing liquidation by Bank of America of the Strategic Cash Portfolio); Study at 18 (discussing the poor performance of two Oppenheimer funds).

33 Study at 14.

34 Study at 19.

products, including their funds. The Study presents no examples or data where any counterparty refused to enter into a transaction with one fund because of the counterparty's concerns with the potential risks associated with another fund or the asset management firm itself. Furthermore, we again emphasize that asset management firms act primarily as agents for their clients and, therefore, do not rely to a significant extent on counterparties.

B. *Sponsor Support*

The Study's risk analysis of implicit sponsor support seems again to rely on a misperception by investors of whether there is sponsor support. First, it does not present any investor survey or other evidence to suggest that investors actually believe that there will be sponsor support or rely on any such belief in analyzing the risk profile of an asset management product. Second, although it makes statements implying that this type of sponsor support is widespread,[35] the Study does not provide any evidence on the pervasiveness of sponsor support, particularly as it relates to all asset management products and not just money market mutual funds.[36] Third, the fact that the sponsor has in the past offered limited sponsor support does not mean that the sponsor will act similarly in the future. Fourth, there is no evidence to suggest that any sponsor has extended support to a product to the extent that the sponsor places itself at risk. Finally, this analysis appears not to recognize the significant restrictions on the provision of sponsor support by banks imposed by the Dodd-Frank Act.[37]

The Study notes that Bank of America supported its Strategic Cash Portfolio fund; however, it also notes that this fund was eventually liquidated.[38] This would suggest to investors that while a sponsor may decide to provide support, there are limits to that support and that the investor is still ultimately responsible for the investment risk.

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[35] *See* Study at 14 (discussing how competitive pressures can lead to guarantees). It is also unclear from these statements whether they refer to money market mutual funds or mutual funds more generally.

[36] The Study presents two anecdotes and a single general statement from unnamed sources but does not provide any empirical data. *See* Study at 14 (discussing Bank of America and OppenheimerFunds anecdotes).

[37] Section 608 of the Dodd-Frank Act revises Section 23A of the Federal Reserve Act to, among other things, restrict the ability of the Board of Governors of the Federal Reserve System to grant exemptions for transactions with any investment fund to which the bank or an affiliate acts as an investment adviser.

[38] Study at 14.

C. *Principal Investing*

On several occasions, the Study explicitly states or implicitly assumes that asset management firms are engaged in significant levels of principal investing,[39] even though that contradicts other statements in the Study that accurately describe asset managers as principally "acting as agents" with small balance sheets.[40] These statements reflect a fundamental misunderstanding of the asset management business.

Asset management firms simply do not engage in principal investing on any significant level. Asset management firms will generally limit their investments to seed investments for new funds and to co-investments that are intended to show investors that, in addition to fiduciary duty and professional reputation, the sponsor and its employees have "skin in the game." These principal investments are also often made through separate legal vehicles that limit the liability faced by the asset management firm itself.

This misunderstanding is also apparent when the Study attributes the ability of an asset management firm to attract clients, retain key employees and deliver asset management services in part *to the financial strength of the manager*.[41] In fact, the strength of the balance sheet is only a minor factor. Absent severe financial distress or imminent bankruptcy, investors and employees rarely consider the strength of an adviser's balance sheet.[42] Because investors are constantly seeking the best investing talent, new asset management firms can rapidly emerge with only a *de minimis* balance sheet.[43]

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[39] *See, e.g.*, Study at 18 ("Sponsors sometimes act in dual roles, as agents who provide portfolio management and other services, and as principals who may invest in their own funds or may provide implicit or explicit support to investors); Study at 26 (expressing concern that a lack of data on the balance sheets of asset management firms could hinder the ability to identify "excessive borrowing or liquidity transformation" at the asset management firm).

[40] *See, e.g.*, Study at 1 ("Asset managers act primarily as agents: managing assets on behalf of clients as opposed to investing on the managers' behalf."); Study at 19 ("As agency businesses, asset management companies tend to have small balance sheets …").

[41] Study at 18.

[42] See Item 18 of Form Part 2A (requiring disclosure only of a financial condition reasonably likely to impair the adviser's ability to meet contractual commitments to clients and not requiring disclosure of firm's audited balance sheet unless the adviser requires prepayment of $1,200 in fees per client six or more months in advance).

[43] *See, e.g.*, Roben Farzad, Jeffrey Gundlach, "Bond Savant," BLOOMBERG BUSINESSWEEK (May 10, 2012)(describing DoubleLine Capital as "the fastest-growing mutual fund startup in history").

The Study raises the concern that there may be complications to risk management due to the fact that large asset managers have subsidiaries in many other countries.[44] Because asset management firms principally act as agents, there are very few firm level-risks, so the risk analysis at the firm level (incorporating the risks of all subsidiaries) is generally simple.

D. *Spillover Between Related Funds*

In addition to the reputation risk discussed above, the Study raises a number of concerns about ways in which risks may be transmitted across funds and, in particular, related funds: (i) known and unknown correlations between different funds managed by the same sponsor;[45] and (ii) redemption behavior of a fund-of-funds investing in funds of its sponsor.[46]

In general, the concerns expressed in the Study about correlations between different funds are misguided. First, although the Study states that there are important niche markets in which related funds and separate accounts are taking significant positions,[47] it is difficult to assess this claim, since the Study does not identify the important niche markets or, among other things, how significant of a share that the funds and the separate accounts are taking, and how important these niche markets are in the context of the U.S. financial system and its stability.

With respect to the concern that an asset manager could misperceive the correlations between different funds managed by a particular asset manager,[48] it is not clear what impact this risk could have beyond those funds. The funds are different legal entities that are not directly or indirectly at risk for the others' liabilities. Moreover, any connection through the asset management firm itself is minimal. It is also unclear how a regulator or other third party would identify a correlation of which the asset manager itself is not aware.

Finally, the Study cites a paper that discusses how funds of funds that invest in affiliated underlying funds may reduce redemptions from underlying funds facing

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[44] Study at 19.

[45] *See* Study at 18 – 19 (discussing unknown correlations between funds managed by the same manager); Study at 22 (discussing large market positions held by a single fund or fund complex).

[46] Study at fn. 48 and the accompanying text.

[47] Study at 22.

[48] Study at 19.

redemption pressure and increase redemptions from the affiliated funds not facing redemption pressure.[49] However, since the paper implies that the scheme is a form of insurance, the distribution of the redemption pressure between the affiliated funds would actually reduce the likelihood of "fire sales" of the assets underlying the funds.

V. Redemption Risk

The Study raises concerns relating to redemptions that echo the money market mutual fund reform initiatives,[50] particularly as it relates to the first-mover advantage leading to a "run" on the fund.[51] The Study, however, does not present any evidence that the first-mover advantage has ever caused a "run" or that it even exists in variable net asset value funds. It also fails to note the ample historical evidence that mutual funds and hedge funds have successfully managed heavy redemptions without causing a financial crisis, much less one that could pose a threat to the financial stability of the United States.[52]

It should be noted that, by the Study's own admission, the redemption risk is primarily limited to only a segment of the asset management industry (*i.e.*, open-end mutual funds). Hedge funds and other similar open-end private funds generally have a variety of tools to deal with heavy redemption requests. This issue also simply does not exist for typical private equity, real estate and other closed-end funds. The Study oddly acknowledges that separate accounts do not face redemption risk either, but then conflates redemption risk with fire sale risk.[53] These are fundamentally different risks that should be analyzed separately. The major transmission risk associated with redemption requests is that more liquid assets may be sold to cover redemption requests,

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[49] Utpal Bhattacharya, Jung Hoon Lee, and Veronika Krepely Pool, "Conflicting Family Values in Mutual Fund Families," Journal of Finance 68, no. 1 (2013): 173-200 ("Bhattacharya, Lee and Pool"). We note that the Study uses this paper to make a more general statement about funds of funds and not just a fund of funds investing in affiliated funds. The "insurance" dynamic identified in the paper would not apply in the case of an unaffiliated fund-of-funds because it would have no incentive to support an unaffiliated fund over another.

[50] *See, e.g.*, FINANCIAL STABILITY OVERSIGHT COUNCIL, Proposed Recommendations Regarding Money Market Mutual Fund Reform (Nov. 2012) ("FSOC MMF Proposal").

[51] Study at 12.

[52] *See, e.g.*, FSOC MMF Proposal, *supra* note 50, at 27 – 28 (discussing heavy redemptions during the summer of 2011.

[53] Study at 15.

potentially spreading the financial crisis. Meanwhile, the risk from a "fire sale" is concentrated principally on the asset being sold. Also, clearly there is no first-mover advantage in separate accounts.

We note that so much of the risk analysis in the Study relies on the presence of redemption risk, including, among other things, the argument of how risk spreads between related funds and from illiquid assets to liquid assets.[54] The Study implies that products that do not face significant redemption risk should not be systemically risky. Thus, the Study seems to view the ability of investors—acting in what they perceive to be their best interest—to redeem shares of mutual funds and similar investments as a systemic risk. However, in our view, redemption activity by mutual fund shareholders is analogous to investment decisions made by millions of investors who elect to sell billions of shares of common stocks that trade on U.S. securities exchanges each day the market is open.

It would be highly unusual to impose restrictions that would restrict trading of equity securities as a means of controlling potential market volatility expected from the reactions of investors to economic or market news (*e.g.*, the release of reports on unemployment, potential changes to the Federal Reserve Board's bond-buying program, and political stalemates associated with the recent government shut-down). Thus, while investors are free to sell their equity securities whenever equity securities markets are open, FSR believes holders of mutual fund shares also should have the freedom to redeem their mutual fund shares each day that the market is open. As a consequence, we see no principled distinction between choices investors make in selling equity securities on securities exchanges and choices mutual fund shareholders make in redeeming their shares each trading day.

VI. Connections with the Financial Industry

The Study groups together a wide range of connections with the financial industry but fails to establish definitively which of the connections could actually transmit systemic risk. Connections through counterparties are fundamentally different than connections through investors or through service providers.

A. *Exposure of Creditors and Counterparties*

As the Study notes, asset management products including registered funds, private funds and separate accounts are connected to banks, insurance companies and other

[54] Study at 12.

financial companies who act as lenders or counterparties to the products. The Study appears to raise a concern that asset managers and funds do not have an overarching counterparty risk management policy, and that some take a fund-level approach.[55] In addition, the Study states that funds are not required to conduct ongoing credit analysis of their derivatives counterparties.[56]

The Study bases these concerns on certain interviews with unidentified asset management firms and the absence of specific regulatory requirements. As noted above, in the absence of further disclosure on the types of asset management firms with whom the Study conducted interviews, it is difficult to evaluate fully these concerns, particularly as it relates to the largest asset management firms.[57] Contrary to the Study's claims, the largest asset management firms generally have highly sophisticated risk management programs both at the individual portfolio level and the aggregate level.

The Study also is misguided in stating that there is no regulatory requirement to adopt a risk management program. Asset managers act as fiduciaries to their clients and, therefore, are responsible for, among many other things, performing credit analyses of counterparties to the extent it is in the best interests of the client. In fact, even in the absence of a specific statute or rule, there is a clear regulatory expectation that asset management firms adopt effective risk management programs covering a range of issues beyond counterparty risk. For example, the Commission staff recently issued guidance on the evaluation of counterparty risk in the tri-party repo market.[58] This recent Commission action demonstrates that it is actively considering risk management issues and that an assessment of the need for and design of any additional regulation should come from the Commission and other capital markets regulators.

B. *Exposures to Investors*

The Study states that having "common, large clients as investors" could result in difficulties.[59] It is unlikely that any single investor is significant enough to the viability of a fund or an investment adviser unless the fund is small or the adviser has only a small

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[55] Study at 21.

[56] Study at 21.

[57] *See supra* note 22 and the accompanying text.

[58] SEC. & EXCH. COMM'N, Division of Investment Management, Counterparty Risk Management Practices with Respect to Tri-Party Repurchase Agreements, IM Guidance Update No. 2013-03 (July 2013).

[59] Study at 21.

amount of assets under management. Large asset management firms and large funds are characterized by a diverse array of investors, and are unlikely to be severely impacted by the withdrawal or failure of a particular investor. Similarly, to the extent a large investor is common across multiple funds or investment advisers, it would appear that the large investor is the systemically significant entity, not the funds or the investment adviser(s) through which it invests.

In particular, the Study raises a concern that fund-of-fund strategies could lead to price declines in illiquid funds which in turn would place increased selling pressure on more liquid funds.[60] We note that the Study cites to a study of the investment behavior of affiliated funds of mutual funds.[61] The theory of investment behavior underlying this paper (*i.e.*, that "cash-rich mutual funds direct capital to family funds that are facing large redemption requests" as a form of insurance) would not apply to unaffiliated funds of funds. Furthermore, the implication of this "insurance" is that this behavior actually reduces systemic risk by reducing the redemption requests to funds facing redemption pressure and, therefore, also reducing the likelihood of a fire sale by the underlying fund.

C. *Exposures to Service Providers*

The Study states that banks and their subsidiaries are providing a variety of execution, administrative and other services to asset managers and funds including broker-dealer services, prime brokerage, fund accounting, pricing and valuation, and custody services.[62] However, the provision of execution, administrative and other services to asset managers and their clients is highly competitive. The Study has not presented any details or evidence on what are the "difficulties" in transitioning from one service provider to another or any reason why these difficulties would present any substantial risk to an asset manager or its clients.[63] For example, it is highly unlikely that the failure of a pricing service provider would lead to increased redemptions from a fund utilizing the pricing services. Furthermore, asset management firms are generally required to adopt policies and procedures to mitigate risks associated with the impact of

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[60] Study at fn. 48 and the accompanying text.

[61] Bhattacharya, Lee and Pool, *supra* note 49.

[62] Study at 21. We also note that the largest banks providing custodial services have already been designated as systemically important financial institutions and, therefore, any regulation of asset management firms for this purpose would be duplicative.

[63] Study at 21. We note that changes in service providers in the asset management industry are not unusual, and asset managers have substantial experience concerning how to effect transitions.

systems failures and other events that could disrupt the firms' business operations, which would cover, among other things, disruptions to their service providers.[64]

VII. Principal-Agent Relationship between an Asset Manager and Its Clients Does Not Create Systemic Risks

On several occasions, the Study inappropriately implies that in some way there are systemic risks as result of the principal-agent relationship between an asset manager and its clients and, in particular, where an investor fails to appreciate the risks taken by the asset manager.[65]

A. *Risk Misperception by Investors*

We object to the overarching implication that investors are ill-informed or misinformed as to the risks of investing in capital markets activities through asset management products.[66] Investing is an activity in which there is always a risk of loss. Investors of all stripes, from the average individual investor to the most sophisticated investor to asset managers of all types, have made investments that have lost money. An investment that loses money does not mean that the investor did not appreciate the risk. In addition, the risks of investments are not static across time. They may become more or less risky for innumerable reasons. It is therefore misguided to attribute all changes in risk perception—or risk tolerance—to an investor's misperception of risk at the time of the investment, and even more misguided to attribute all such misperceptions to asset managers.

As noted in the Study, there is significant regulation of both registered funds and registered investment advisers with respect to disclosures of risks and limiting conflicts

[64] *See, e.g.,* Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204 (Dec. 17, 2003).

[65] *See, e.g.,* Study at 9 – 10 (discussing "reaching for yield"); Study at 11 – 12 (discussing mutual funds that invest in private funds); Study at 18 (discussing actions against sponsors for misleading investors about leverage).

[66] *See, e.g.,* Study at 9 (stating that "investors might not fully recognize or appreciate the nature of risks taken by their portfolio managers, despite required disclosures and investment mandate restrictions"); Study at 11 – 12 (expressing concern about "investors who failed to appreciate the risks of [investments in mutual funds investing in private funds]"); Study at 18 (discussing actions against sponsors for misleading investors about leverage).

of interests between asset managers and their clients.[67] The Study even implicitly acknowledges that the Commission has brought enforcement actions focused on this issue.[68]

In most cases, the risks the Study describes are nothing more than standard risks associated with investing. For example, it appears that the risk identified in the Study as being associated with "reaching for yield,"[69] leverage,[70] and complex strategies[71]—*i.e.*, that the risks may become "suddenly apparent" to the investor and lead to significant redemptions or sales[72]—appears to apply to any situation where the investor (and potentially the asset manager) misperceives the risks involved (*e.g.*, the market as a whole fails to perceive the risks involved in investing in Enron or WorldCom).

The Study, however, fails to provide any data that the portion of these misperceptions attributable to behaviors of the asset managers is systemically significant. If there is limited misbehavior by a small number of market participants, it does not threaten the financial stability of the United States. In other words, the category of risk misperception by investors is substantially larger than those misperceptions that can be attributed to the principal-agent relationship between an investor and an asset manager. In addition, it is difficult to distinguish between a risk misperception issue and the expected behavior of the capital markets—*i.e.*, new information on an asset becomes available and the market adjusts to reflect that new information. This point is implicitly acknowledged when the Study notes that even if the risk perception mismatch from the principal-agent relationship is fully mitigated through disclosure and other limits on conflicts of interest, the existing regulation "does not always address collective action problems and other broader behavioral issues that can contribute to asset price bubbles or other market cycles."[73] Asset price bubbles and similar risks exist regardless of an incentive mismatch between an asset manager and its clients.

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[67] *See* Study at 9 – 10. *See also supra* note 18 and the accompanying text (discussing the relevant regulatory régimes).

[68] *See* Study at 18 (discussing actions brought against OppenheimerFunds and State Street relating to misleading disclosures).

[69] Study at 9 – 10.

[70] Study at 18.

[71] Study at 11 – 12.

[72] Study at 9 – 10.

[73] Study at 10.

B. *Herding Behaviors*

A similar analytical flaw appears in the discussion of "herding" behaviors by asset managers. The academic papers the Study cites do not actually show that this "herding" behavior is significant across all types of assets—rather, it appears to be limited to securities of issuers with small capitalizations.[74] It is also difficult to distinguish the concern with respect to "herding" behavior among asset managers from more general concerns about asset price bubble formation. Investments by asset managers as a primary matter reflect the direct or indirect demand for certain types of assets or portfolio strategies by their investors. The increased investing in fixed income securities reflects an increased demand from investors and should not be attributed to the competitive behavior of asset managers. "Herds" also could be composed of a large number of small investors or funds managed by smaller asset managers. It is difficult to see what possible regulatory action the Council could consider out of this observation that would not be effectively characterizing investing in capital markets as systemically risky, which would be a substantial regulatory overreach.

Furthermore, there are countervailing forces to this "herding" behavior that the Study fails to note. Capital markets already include a self-correcting mechanism to dissuade "herding" behavior since the underlying assets become more and more expensive as the "herd" grows. This is why a significant percentage of asset managers focus on "undervalued" assets.[75]

The examples of "herding" behavior cited in the Study also seem severely flawed. First, the Study discusses ETFs; however, passively-managed ETFs remain substantially larger than actively-managed ETFs.[76] It is unclear how a passively-managed ETF would exhibit a "herding behavior" that could be attributable to its sponsor, other than to the extent it reflects indirect investor demand. Second, the Study hypothesizes that investors could "herd" into mutual funds investing in private funds. Not only does this example conflate "herding" by investors with "herding" by asset managers,[77] there appears to be

[74] See academic papers cited in fn. 8 of the Study.

[75] *See, e.g.*, Matt Krantz, "Buy high and sell higher? Better stick with value investing," USA TODAY (May 21, 2007)(discussing the difference between growth or momentum investors and value investors, who "look for stocks they believe are undervalued relative to their true or 'intrinsic' value").

[76] Conrad De Aenille, "Active E.T.F.'s, Still Trying to Make Waves," NEW YORK TIMES (Oct. 5, 2013)("The 64 actively managed E.T.F.'s in Morningstar's database had about $14.4 billion in assets at the end of July, the latest data available. That is compared with $1.5 trillion in passively managed, index-tracking E.T.F.'s and $10.2 trillion in mutual funds.").

[77] The Study had previously defined "herding" as "the tendency of *asset managers* to crowd into similar, or even the same, assets at the same time" (emphasis added). Study at 10.

no evidence that any such "herding" has occurred. Furthermore, this example appears to overstate the risks of mutual funds investing in private funds by continuing the practice of generalizing about private funds based on a certain segment of hedge funds[78] and by failing to describe how redemption pressure could translate to unmanageable redemption pressure at the private fund level.[79]

VIII. Leverage

The Study's analysis of the risks associated with leverage suffers from many of the defects identified above. One must clearly distinguish between leverage utilized by the asset management firm itself (on its own balance sheet) and leverage embedded in products offered by the asset management firm and disclosed to investors in those products. Asset management firms do not generally utilize substantial leverage with respect to their own limited principal investments.

With respect to leverage in asset management products, the Study notes that certain strategies rely on leverage to change the risk-return profile of an investment.[80] While leverage will change the risk-return profile of a strategy, the use of leverage does not inherently delegitimize the strategy because it involves greater risk than other types of investments along the "risk-reward" continuum. In fact, an investment without leverage may present greater investment risk than an investment with leverage. Moreover, much like the discussion of "herding" behavior, this concern is difficult to distinguish from a more general concern about the riskiness of investing in capital markets. As we have repeatedly noted, this concern reveals a misunderstanding of the inherent nature of the capital markets. The increased investment risks associated with investing in an asset management product with leverage does not create the same maturity mismatch issues that may arise with respect to, for example, leverage incurred by banks. Furthermore, as discussed above, the limited misbehavior of certain asset

[78] For example, not all private funds incur substantial leverage or engage in complex trading strategies. In particular, neither of these characteristics is common in private equity funds, real estate funds or even in all hedge funds.

[79] The Study acknowledges elsewhere that the private funds have more tools available to manage redemption requests. *See* Study at 12 ("In contrast, private funds are often structured to permit temporary suspensions of redemptions or the imposition of redemption fees or gates that limit redemptions in times of stress.") Moreover, even supposing the fact that the redemptions at the mutual fund level threaten the viability of the private fund, the only way in which this creates a systemic risk is if the private fund is substantial enough in size to be systemically risky itself.

[80] Study at 17.

management firms who may mislead investors as to amount of leverage utilized should not be ascribed to the industry at large.[81]

IX. Data Gaps

FSR has three major concerns with respect to the Study's discussion of data gaps concerning the oversight of asset management firms and activities. First, the lack of data and analysis in the Study suggest that OFR has not analyzed the enormous volume of data that asset management entities (funds and advisers) already report to various regulators, including other Council members.[82] Second, the Study appears to dismiss the significant costs to asset management firms with respect to any new reporting requirements without any analysis.[83] Third, there are significant flaws with the justifications as to why the information is necessary for an analysis of systemic risk.

In our view, an objective analysis of the characteristics of separate accounts and information already available to regulators would likely lead one to conclude that additional data collection would not justify the regulatory burden. Separate accounts (i) are not subject to redemption risk since they hold the underlying assets directly,[84] (ii) can more easily change managers,[85] (iii) of any significant size are held by very sophisticated investors with extensive internal investment, legal and other relevant

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[81] *See supra* Section VII.A.

[82] Asset management firms are already required to make numerous filings with a wide range of information under the Advisers Act (including Form ADV and Form PF), the Investment Company Act (including Form N-1A and N-Q), the Commodity Exchange Act (including CPO-PQR and CTA-PR), and ERISA (including Form 5500). We note that many of these reporting requirements were implemented following the 2008 financial crisis and the adoption of the Dodd-Frank Act.

[83] Study at 24.

[84] Study at 15. We note the presumption that separate accounts may still engage in significant selling seems to ignore the particular risks relating to increased redemptions, including, in particular, the first mover advantage, which does not exist in the separate account context.

[85] Study at 19. We note that the Study provides no data or empirical evidence to support its concern that the new manager may not be able to replicate the same complex, highly customized strategy. In fact, there are experienced "transition managers" who specialize in these services and separate account assets also are often transferred "in-kind."

expertise, and (iv) do not have any pooling of assets so are unlikely to reach systemically important size.[86]

Furthermore, any *de minimis* benefit from increased disclosure must be weighed against the fact that there are a large number of separate accounts, substantially all of which could not be systemically significant under any analysis. The reasons stated by the Study for requiring the disclosure are also flawed: (i) asset managers are already required to disclose the assets relating to "parallel managed accounts" on Form PF, so the regulators already have information relating to the ability of these accounts to "magnify the impacts" of private funds engaging in substantially similar strategies;[87] and (ii) separate accounts engaging in "highly bespoke" strategies are unlikely to follow similar strategies due to the inherent nature of customizing the strategy for each separate account.

We further believe that the analysis regarding the data gap concerning the financial statements of asset management firms neglects the fact that many major asset management firms already disclose their financial statements, and incorrectly states that the strength of the balance sheet of an asset management firm is important to analyzing its potential systemic risk. Many asset management firms are required to disclose their financial statements in a variety of contexts.[88] In addition, as noted above and in the Study, asset management firms generally have small balance sheets and do not engage in principal investing.[89] The Study, however, appears to ignore this fact when it states that the data is necessary to evaluate whether there is excessive borrowing or liquidity transformation by asset management firms that could pose a threat to financial stability.[90] The Study presents no data or economic model of how the strength of an asset management firm's balance sheet is related to its assets under management or to the financial stability of the United States.

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[86] Even an investor who is itself systemically significant would be unlikely to invest all of its assets or a systemically significant portion of its assets in a single separate account. These investors are more likely to spread their assets across multiple asset managers with differing expertise.

[87] Form PF, Question 11.

[88] For example, an asset management firm would be required to disclose information regarding its balance sheet if it (i) also was registered as a broker-dealer (Form 17-H), (ii) was a public company, or (iii) issued Rule 144A securities.

[89] Study at 19.

[90] Study at 26.

Although many do not report their financial statements publicly, registered investment advisers are required to make disclosures regarding “any financial condition that is reasonably likely to impair [their] ability to meet contractual commitments to clients.”[91]

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[91] Form ADV, Part 2A, Item 18.

FSR appreciates the opportunity to submit comments on the OFR's analysis of the asset management industry. If it would be helpful to discuss FSR's specific comments or general views on this issue, please contact me at Rich.Whiting@fsroundtable.org or Rich Foster at Richard.Foster@fsroundtable.org.

Sincerely yours,

Richard M. Whiting

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With a copy to:
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The Honorable Luis A. Aguilar, Commissioner
The Honorable Daniel M. Gallagher, Commissioner
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